of the acquisition of the interest, it *cannot* directly affect the behavior of the acquired service. Although silent financial interests are often small, even a large interest can be silent if it is accompanied by (for example) binding commitments to insulate management from control by the investor.

Ownership Interests That Convey Partial Control or Influence

Finally, managers may respond to owners with large financial interests by accounting for the effects of their managerial decisions on the profits of owners that do not exercise direct control. For example, managers may believe that their job security or compensation is at risk if they take actions that adversely affect the profits of one or more owners with large financial interests. In this case, control of the firm is partial, because the extent of control of any individual owner depends on the magnitude of its interest, the magnitude of the interests of other large investors, and the source of profits of other large investors. Control of the firm is indirect, because it relies on managers having the incentives to serve the interests of large investors without explicit direction.

However, the extent of this "indirect" control should not be overstated. In fact, it may not exist at all in many situations. Partial ownership may not result in meaningful control because of the threat of shareholder suits, or by increases in the cost of capital, that might arise if the managers ignore the interests of other shareholders. The more conflicting are the various ownership interests, the more likely is management to focus on maximizing the value of the firm as a stand-alone entity.

Evaluating the Competitive Significance of a Financial Interest When the Firms Are Horizontal Rivals

Consider a circumstance in which one program service acquires a minority ownership interest in a rival service that conveys less than complete control. Because the acquired firm and the investor compete, the intensity of price competition may be reduced (ignoring entry, the effect of other competitors, and other relevant market responses that may affect price competition). This occurs because, if the investor competes less aggressively, the profits of the acquired firm will rise and the investor will share in the higher profits by virtue of its financial interest. In addition, if the interest conveys some control, the acquired firm will also compete less aggressively, further increasing the profits of its investor.

However, the extent to which these incentives actually manifest themselves in reduced competition depends on a number of factors. A larger financial interest in the acquired firm yields a larger incentive to compete less aggressively (because the acquirer captures a greater share of the higher profits experienced by the acquired firm). The larger is the market share of the acquired firm, the greater is the increase in the profits of the acquired firm when the investing firm competes less aggressively. The greater is the market share of the investor, the greater is its profit when the acquired firm competes less aggressively. The greater the control conveyed by the financial interest, the larger would be the effects on suppressing competition. Finally, the more closely aligned are the interests of all owners, the larger may be the anticompetitive effect from the financial interest.[11]

[11] For example, in the case of partial control, if other minority investors with partial control are also rivals of the acquired firm, the price effects will be increased because all investors benefit from reduced price competition.

Measuring Market Concentration

The previous discussion highlighted the complexity of a complete evaluation of the competitive significance of a financial interest acquired by one firm in another. In this section, we apply the principles discussed above to analyze the effect of the AT&T-MediaOne merger on concentration in the supply of program services. In this regard, we present a metric to measure the effects of an acquisition of a partial ownership interest by one program service in a rival. The metric takes into account the market share of the acquiring firm, the share of the acquired firm, the shares of the other firms in the industry, and the size of the acquired ownership interest. . We stress at the outset that, if anything, our analysis is highly conservative because it ignores the effect of entry, the effect of other competitors, and other relevant market responses that may effect price competition.

The Modified Herfindahl-Hirschman Index

One way to account for the effects of partial financial interests is through a more refined construction of the concentration index than the mechanical approach taken by CFA. We are aware of only one index that does so in any rigorous way: the modified Herfindahl-Hirschman Index, or "MHHI."[12]

The MHHI recognizes that three factors are important for measuring concentration: ownership, control, and market shares. Like the HHI, the index places greater weight on firms with larger shares. In addition, the index properly accounts for how partial ownership interests affect incentives.

[12] *See* T.F. Bresnahan and S.C. Salop, "Quantifying the Competitive Effects of Production Joint Ventures," *International Journal of Industrial Organization* 4 (1986): pp. 155-175. The theoretical underpinnings of our MHHI analysis is set forth in Appendix A.

In one case of concern — a silent financial interest — the MHHI is simple to calculate. If firm A takes a silent financial interest of α% in firm B, and the firms have no other partial ownership interests, the MHHI is calculated as:[13]

$$MHHI = HHI + (\alpha/100) \times S_A \times S_B$$

where S_A and S_B are the market shares of firms A and B, respectively, and HHI is the measure of concentration if there were no overlap in ownership among firms. That is, prior to firm A's acquisition of a partial interest in firm B, the MHHI is equal to the HHI. The effect of firm A's acquisition of a partial interest in firm B is thus to raise the ordinary HHI by an amount equal to the fractional partial ownership interest times the share of firm A times the share of firm B.

A simple way to think about the MHHI in the context of evaluating the competitive significance of silent interests is as follows: Absent any partial ownership interests, the MHHI is equal to the standard HHI. If firm A takes an α% interest in firm B, the MHHI increases by $(\alpha/100) \times S_A \times S_B$.[14] If firm A had instead merged with firm B, the HHI would have increased by $2 \times S_A \times S_B$.

A numerical example helps illuminate the difference between the HHI, which is appropriate for 100% ownership interests, and the MHHI, which is appropriate for partial ownership interests. Suppose that firms A and B each have 30% market shares. If firm A merges with firm B, the HHI increases by 1800 (= 2 x 30 x 30) points. However, if firm A takes a 5% silent financial interest in firm B, the MHHI

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[13] *See* Appendix A.

[14] If firm A acquired a 50% silent financial interest in firm B and firm B acquired a 50% silent financial interest in firm A, the MHHI would rise by the product of the two shares. Because the interests are silent, the increase in the index would still be smaller than in the case of a merger of the two firms (in which case the index would increase by twice the product of the two shares).

rises by only 45 (= .05 x 30 x 30) points. In this example, treating a 5% silent financial interest as a complete merger would overstate the impact of the acquisition on concentration by 4000%!

The above example assumes that the partial ownership interest is silent, i.e., non-controlling. An alternative assumption is that the control or "influence" that an owner has over the manager of the firm in which it has a partial ownership interest is proportional to the owner's partial interest.[15] More precisely, one can assume that the manager of a partially owned firm maximizes a weighted average of the owners' profits, where the weight given to each owner's profits is equal to its ownership interest. The MHHI makes it possible to account for ownership this way. (See Appendix A.) However, as we observed above, the ability of managers to act in this way is limited by the threat of shareholder suits, among other factors.

Calculating the MHHI

We have calculated the MHHI in the supply of program services under alternative assumptions about the extent to which AT&T controls and has a financial interest in Liberty and about the nature of the financial interest in TWE acquired by AT&T as a result of the merger.

Case 1 assumes that AT&T and Liberty are completely separate entities, while Case 2 assumes that Liberty is fully owned and controlled by AT&T.[16] In both

[15] In the spectrum of control possibilities between a financial interest that is silent and one that conveys complete control, there are many possible ways to characterize the effect of partial control. Depending upon the particular interest acquired, whether there is another owner with a larger interest that is effectively controlling, the size of the interests of the other major investors, the significance of public shareholders, and other factors, the extent of partial control may be more or less than proportional.

[16] Although these are natural cases to consider, we understand (as noted above) that the actual relationship between AT&T and Liberty is much closer to Case 1.

cases, we assume that all owners of a program service exercise proportional control over the management of the service (i.e., their voting shares are equal to their ownership shares), with some significant exceptions. We understand that Liberty's 9% financial interest in Time Warner and its 8% interest in News Corp. are non-voting and therefore are treated as silent. For reasons discussed previously and in the Public Interest Statement, we also assume that AT&T's 33% financial interest in Cablevision is silent. Finally, we treat AT&T's interest in TWE as silent after the merger.

Cases 3 and 4 are similar to cases 1 and 2, respectively, except that MediaOne's interest in TWE is assumed to convey proportional control after the merger, although, for reasons already discussed, we believe that this substantially overstates any control that AT&T may have. In all cases, our analysis includes 61 basic program services and 9 premium services.[17]

As reported in Table 1 (attached to the end of this report), the AT&T-MediaOne merger increases the MHHI by only 48 if Liberty is treated as separate from AT&T, and by only 104 even if Liberty is assumed to be completely controlled by AT&T. (See cases 1 and 2 in Table 1.) This is about one-tenth of the size of the change estimated by CFA. Moreover, while CFA calculates a post-merger level of concentration in excess of 2500, the more appropriate calculation here indicates that the post-merger MHHI is only slightly above the "moderately concentrated" threshold of the *Horizontal Merger Guidelines*. This conclusion is little changed

[17] This is the universe of services for which revenue data were available. See the sources listed in Appendix B.

even in cases 3 and 4, where AT&T is assumed to have proportional control of TWE after the merger. Indeed, if Liberty is assumed to be separate from AT&T, the change in concentration is even smaller where control of TWE is assumed to be proportional.[18] In any event, the competitive effects of these small increases in concentration, even if they were empirically important, could likely be easily offset by the entry of new program services (including additional services from existing providers). Moreover, as noted above, this MHHI analysis overstates the competitive impact of the merger. Barriers to entry into the programming market are low.

In addition, the calculations reported in Table 1 fail to account for other sources of programming that compete with MVPD program services for the patronage of consumers. These sources would include broadcast television, movies for theatrical release, and pre-recorded videocassettes. For example, inclusion of revenues from the sale of videocassettes in the MHHI analysis (which accounts for the financial interest of MVPD program service owners in the sale of videocassettes) would result in post-merger MHHIs below 1800 for all cases, with a maximum change in the MHHI of 87, i.e., within the Horizontal Merger Guidelines "safe harbor" for moderately concentrated industries.

[18] It may seem surprising that if Liberty is treated as an independent firm, the change in the MHHI is larger when, post-merger, MediaOne's interest in TWE is largely silent (Case 1 vs. Case 3 in Table 1). This occurs in this calculation because, after the merger and as a result of the merger, Time Warner will now have effective control over TWE. If MediaOne's interest in TWE becomes silent after the merger, Time Warner will have full control of TWE. As a result of the merger-induced increase in Time Warner's control of TWE, Time Warner will have a greater ability to make the TWE services compete less fiercely against the Turner services (in which Time Warner has a 91% ownership share). This is reflected in the larger MHHI change in Case 1 versus Case 3. Of course, as noted in the text, all of the MHHI changes are relatively small.

Summary

CFA assumes that the AT&T-MediaOne merger is also a merger between AT&T and TWE and between AT&T and Time Warner. As a result, CFA attributes a substantial change in program service concentration to the AT&T-MediaOne acquisition. However, because AT&T's acquisition of a partial ownership interest in TWE is not equivalent to a merger among AT&T, TWE, and Time Warner, the CFA approach greatly overstates the competitive significance of the merger. The more appropriate accounting of partial ownership interests conducted here reveals that, in fact, the change in concentration is only a small fraction of that estimated by CFA and presents little competitive concerns.

The Effect of Competition from DBS

In his Declaration, Professor Hausman asserts that cable systems exercise unconstrained market power. In particular, Hausman claims that the competitive check afforded by DBS and other wireless providers to cable system pricing is not competitively important.[19] This assertion appears to be driven largely by two putative "facts." First, Hausman claims that while DBS prices have been falling, cable prices have been rising.[20] Second, Hausman claims that the lower cable prices in those franchise areas that have two rival cable systems demonstrate "the lack of an effective price constraint by DBS."[21]

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[19] Declaration of Jerry A. Hausman Filed on Behalf of SBC, August 23, 1999 (Hereafter "Hausman Declaration"), pp. 3-5. *Breaking the Rules*, p. 50, makes a similar claim when it contends that the FCC's decision to include DBS in calculating market concentration "is not justified."

[20] Hausman Declaration, p. 4.

[21] *Id.* Hausman also asserts that DBS's inability to carry local stations and its high upfront costs deter consumers from purchasing DBS. However, both DirecTV and EchoStar offer consumers the

With respect to the first claim, it is notable that the FCC observes that some of the cable rate increase "is attributable to capital expenditures for the upgrading of cable facilities, an increase [sic] number of video and non-video services offered, and increased programming costs."[22] It is not altogether surprising that cable service prices have increased to reflect increases in the costs and quality of the services that are offered. At the same time, the Commission quotes the Strategis Group as finding that "[DBS] equipment costs have spiraled downward," which explains much of the DBS price reduction.[23]

With respect to the second claim, it is unremarkable that the entry of a second cable system in any particular franchise area would reduce MVPD prices. Prior to that entry, the local supply of MVPD services might have been shared (for example) among the local cable operator, DirecTV, and EchoStar. In these circumstances, the entry of a fourth provider could have the effect of lowering prices charged by all providers, including the DBS rivals. The fact that cable prices are lower in overbuilt areas does not preclude the possibility (one that we regard as likely) that the presence of DBS constrains cable prices in all areas, whether overbuilt or not.

In contrast to Hausman's view, most knowledgeable observers have concluded that DBS is a significant rival to cable systems. Indeed, the Antitrust Division of the Department of Justice recently concluded:

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option of purchasing an over-the-air antenna as part of the dish. In addition, the Fifth Annual Report, para. 73, notes that upfront costs have been declining rapidly.

[22] Fifth Annual Report, para. 47.

[23] *Id.*, para. 73.

> Cable and DBS are both MVPD products. While the programming services are delivered via different technologies, consumers view the services as similar and to a large degree substitutable. Indeed, most new DBS subscribers in recent years are former cable subscribers who either stopped buying cable or downgraded their cable service once they purchased a DBS system. Cable and DBS compete by offering similar packages of basic and premium channels for a monthly subscription fee.[24]

Similarly, the Federal Communications Commission has observed that:

> DBS continues to represent the single largest competitor to cable operators and DBS subscribership continues to show strong growth. The four DBS providers furnished programming to more than 7.2 million subscribers as of June 1998. This is an increase of more than 2.2 million subscribers since June 1997, or nearly 43%. In addition, industry reports state that 2.2 million of the 3.6 million net new MVPD subscribers in 1998, or almost two thirds, are choosing DBS. The Strategis Group projects that DBS subscribership will grow to 20 million by 2003, with its share of the multichannel video market growing to 25%. *SkyReport*, a trade publication that tracks DBS subscriber growth, estimates that DBS will have 15.2 million subscribers by 2002.[25]

As the above quotation suggests, while DBS imposes a significant constraint on cable system pricing behavior, the competitive significance of DBS is understated by its current market share because DBS has been growing very rapidly.

The very rapid growth in DBS subscribership in recent years, the virtually ubiquitous coverage of DBS operators, and analyst projections for near-term DBS growth all indicate that the video marketplace cannot be analyzed without considering the substantial impact of DBS on cable system behavior. As we emphasize below, the entry and growth of DBS have not only provided additional alternatives to subscribers but have also reduced whatever power large cable

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[24] *United States of America v. Primestar, Inc. et al.*, filed in the United States District Court for the District of Columbia, May 12, 1998, para. 63.

[25] Fifth Annual Report, para. 62, footnotes omitted.

MSOs have over program services. In particular, by increasing the number and importance of alternatives to cable, the growth of DBS has reduced the ability of AT&T and other large MSOs to exercise monopsony or engage in vertical foreclosure. This would be true even if cable and DBS served completely distinct sets of subscribers. For example, although MSOs in Canada do not compete with those in the US, they still provide an outlet for much of the same video programming that appears on U.S. cable systems.

The Issue of Monopsony

In his Declaration, Hausman asserts that a large cable operator can unilaterally exercise monopsony power against program services.[26] According to Hausman, a large cable operator can extract lower prices from the program services by threatening not to carry the service, thereby reducing the revenues of the program service. Hausman thus concludes that "if a cable channel receives below the competitive price for its programming or receives lower advertising revenues, it will have an economic incentive to decrease the quality of its product and spend less on content creation."[27]

Hausman also asserts that this same leverage will permit the large MSO to demand an "ex post [ownership] share... in successful cable packages," an outcome that will again "lead to a reduction in investment and lower quality cable offerings."[28] Hausman then goes on to assert that the merged AT&T will certainly

[26] Hausman Declaration, pp. 8-11.
[27] *Id.*, p. 9.
[28] *Id.*, p. 11. As discussed in greater detail with respect to AT&T's incentive to foreclose rival program services, a large MSO's threat not to carry popular services such as MTV, ESPN, or CNN is simply not credible because failure to carry such services would likely result in a significant decline in

be sufficiently large to exercise such leverage. Even if AT&T alone cannot exercise that power, Hausman claims that AT&T in coordination with other large MSOs can collectively exercise that leverage. Hausman (and CFA) provide estimates of the size of AT&T and of concentration in cable system ownership as support for this alleged harm.

Hausman is incorrect for a number of reasons. First, AT&T currently and after the merger is unlikely to possess monopsony power. Importantly, AT&T's purchases of program services likely account for a relatively small share of the market in which the services compete for inputs, and will continue to do so even after the merger.

Second, Hausman (and CFA) overstate the size of AT&T and the effects of the merger on coordination among MSOs in exercising monopsony power by assuming that a partial ownership interest in cable systems is equivalent to complete ownership and control of those systems by the owners of the partial interest.

Finally, even if AT&T did have the ability to exercise monopsony power, it would not likely be exercised in a way that resulted in fewer or lower-quality program services. Indeed, a larger MSO may have an incentive to pay *higher* program service prices (other things equal) than a smaller MSO in order to ensure

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subscribership, including subscribers who would switch to DBS. Thus, the threat could only be credible against less popular program services. However, many such services seem to have survived and thrived with penetration rates that are quite modest. For example, FiT TV is on systems serving only 14.1% of all MVPD subscribers and Eye on the People is on systems serving only 13.8% of all MVPD subscribers. (Data are from the Fifth Annual Report.) For these services, the threat is also not likely to be credible because non-carriage will not result in their demise or in a significant quality reduction of the services.

that the number and quality of the program services are not diminished by "free-riding" by smaller MSOs on the payments made by larger MSOs. In other words, the AT&T-MediaOne merger may lead to greater efficiency in the market for program services by reducing the extent to which the quality and variety of the program services are "public goods." In what follows, we explain why the circumstances in which monopsony power can lead to consumer harm by reducing the quantity or quality of program services are highly unlikely to be realized in the sale of program services.

The Hausman-CFA Approach to Measuring AT&T's Subscriber Share Is Flawed

As the merging parties noted in their Public Interest Statement, the post-merger AT&T will purchase programming for only about 27%[29] of MVPD subscribers. The subscriber control they provide to AT&T is significantly less than the 35% threshold specified in the *Horizontal Merger Guidelines*.

Professor Hausman disagrees with this measurement of AT&T's size. According to Hausman, the financial interests that AT&T has in other cable systems will apparently facilitate tacit coordination among MSOs for the purchase of program services:

> Given that the economic interests of cable MSOs coincide on many economic issues, such as achieving low programming costs from third party providers, direct control is not required for cable MSOs to decide jointly to bargain together, or at least to take similar negotiating positions when bargaining with outside suppliers. Thus, affiliated cable MSOs should be considered in the competitive

[29] Public Interest Statement, p. 55.

> analysis of the merger, rather than limiting the analysis only to cable MSOs that are directly controlled by the merged company.[30]

Whatever incomplete inferences regarding the exercise of monopsony power that might be drawn from the pre- and post-merger size of AT&T have been completely distorted by Hausman (and by CFA). Hausman implicitly assumes that any cable system in which AT&T has as little as a 5% ownership interest should be treated the same as a system that is totally owned and controlled by AT&T. Using this approach, Hausman estimates that AT&T will have a post-merger MVPD subscriber share of about 48%[31], as opposed to a 29%[32] share if only subscribers to systems directly controlled by AT&T are counted (or 27% if only subscribers for whom AT&T purchases programming are counted). CFA apparently follows a similarly flawed methodology and reaches a similar conclusion.

Hausman also uses this methodology to assert that, nationwide, the HHI in the sale of services to MVPD subscribers will increase by nearly 1100 points[33] as a result of the merger. Using homes passed by cable systems (i.e., ignoring DBS subscribers), CFA asserts that the HHI will rise by over 1200 points.[34] According to Hausman, this increase in the HHI will significantly increase the likelihood that MSOs will be able to present a united bargaining front in negotiations with program services.

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[30] Hausman Declaration, p. 7, footnotes omitted.
[31] *Id.*, p. 7.
[32] *Id.*, p. 6.
[33] *Id.*, p. 7.
[34] *Breaking The Rules,* p. 54.

The approaches adopted by Hausman and CFA grossly distort any inference about changes in monopsony power that one might be able to draw from the changes in the "size" of AT&T as a result of the merger. First, Hausman's approach requires that the price that AT&T pays to (say) MTV is linked to the price that a partially affiliated cable operator pays for MTV. But cable operators do not "compete" with each other in the purchase of programming. This is because a sale by MTV to one operator does not preclude the sale of the same service to a second operator. Thus, there is no necessary linkage between the price MTV obtains from one operator and that obtained from another.

Such a linkage could occur if all cable MSOs explicitly bargained jointly, as Hausman suggests, but in fact there is no such joint bargaining. It is not at all apparent what "tacit joint bargaining" means, or how it could achieve an outcome similar to that for explicit joint bargaining. For example, if AT&T bargained aggressively with a program supplier, the price charged AT&T might be lower than otherwise. But Hausman never explains how a second MSO would benefit from the bargain obtained by AT&T and, therefore, how AT&T's acquisition of a silent financial interest in the second MSO would result in AT&T becoming a more aggressive bargainer.

Even if we assume that any lower price AT&T obtains would benefit other cable operators, the Hausman and CFA approach is flawed because it treats a partial financial interest by AT&T in other MSOs as equivalent to a merger between AT&T and those MSOs. In effect, this approach implicitly assumes that the competitive significance of a 5% financial interest by AT&T in another MSO is

equivalent to that of a 100% interest in the same MSO. Yet, the incentives for AT&T to take actions that benefit the other MSO are not independent of the size of that financial interest. The larger the financial interest, the greater the incentive for AT&T to act in a way that benefits the other MSO. For the reasons stated more fully above, the approach of treating the two interests as equivalent, and both as equivalent to a full merger, defies both economic and common sense.[35]

Moreover, in order for a large MSO to use its buying power in a way that adversely affects viewers, it would have to decline to carry some program services that would otherwise be profitable to carry, or compel a reduction in its program quality, and the effect would have to be to reduce the prices at which other program services could be purchased. In the standard monopsony analysis, a single purchaser faces an upward-sloping supply curve, i.e., as the quantity supplied increases, the cost of supplying additional quantities also increases. In these circumstances, additional purchases increase the price paid for all units purchased. Thus, the purchaser recognizes that the cost to it of purchasing additional quantities of the input includes not only the price paid for those additional units, but also the increased payment on all other units purchased. For this reason, the monopsonist restricts the amount purchased. By contrast, if there were many small buyers, each would ignore any effect of its purchases on prices because its individual purchases would have a negligible effect on price and, thus, all buyers together would purchase more than would a monopsonist.

[35] A more appropriate accounting for these partial financial interests yields a change in the MHHI of at most about 380 and a post-merger MHHI of at most about 1450, well within the *Horizontal Merger Guidelines* characterization of a "moderately concentrated" industry. (See Table 2 and Appendix C.)

There are a number of reasons to believe that AT&T will lack the ability or incentive to reduce the prices paid for programming in a way that restricts the supply of programming. First, available evidence does not indicate that increased purchases of program services will result in substantial increases in program services' input costs during any medium or long-term time horizon.[36] The rapid expansion of the number of program services that has occurred during the space of only a few years suggests a relatively elastic supply of many of the inputs that are used by program services.[37]

Second, and related to the first point, program services compete with other purchasers for the inputs used to produce the services. Thus, the services compete for inputs (writers, directors, actors, etc.) with suppliers who create programs for television broadcast stations (first-run syndication) and networks, with the movie studios in the production of first-run theatricals, and with live theatre, among others. Thus, in this broader market, AT&T's purchases are likely to have little or no effect on price.[38] That is, AT&T would perceive the relevant program service supply curve to be quite elastic.

Third, as discussed extensively above, DBS provides an increasingly important alternative outlet for program services. As a result, the ability of any large

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[36] Put somewhat differently, over these time periods, the relevant antitrust market is not likely to be limited to those inputs used in producing specific types of program services.

[37] There were 147 national cable program networks at the end of 1996 and 245 at the end of 1998. The sources for this calculation were those provided in footnote 10.

[38] One (somewhat imperfect) indicator of AT&T's relative unimportance in this broader input market is its share of the revenues of downstream providers using these inputs. MVPDs account for about 40% of the combined revenues of MVPDs, broadcast networks and stations, theatrical motion pictures, and videocassettes. Even if AT&T accounted for 50% of all MVPD revenues, it would account for only 20% of revenues of all purchasers of programming inputs.

MSO, including AT&T, to bargain successfully for below-competitive prices from the program services has correspondingly diminished. Indeed, this would be true even if DBS and cable systems had completely distinct and non-competing subscriber bases because DBS and cable systems offer their respective subscribers the same programming.

Finally, even if AT&T increases its demand for services and the service supply curve is upward-sloping, it might still be able to pay the higher price only for the *additional* services, without causing the prices of the other services to increase. If this were the case, then the monopsony would not result in fewer services being purchased.

Some cable program services have higher costs than others, and demand, and receive, higher fees from cable operators. Those higher costs, in turn, may reflect the higher quality of those cable services. So long as paying for a higher-cost service does not increase the price that must be paid for a lower-cost service, AT&T has no incentive to restrict its purchases in order to exercise market power. Thus, large MSOs may be able to limit the prices they pay for some program services without having to restrict their purchases.

Bargaining over the price of program rights and program inputs is a common phenomenon throughout the video, entertainment, and sports industries. Some programming and sports events, and, in turn, some of the talent responsible for such programming and sports events, generate revenues in excess of the value those inputs could generate in their next-best use. In other words, such programming and inputs into programming generate revenues in excess of the

minimum costs that must be paid to command their use. That means there is room for bargaining between buyer and seller over the difference between the minimum amount the seller must be paid and the maximum amount the buyer would pay.

There is little room for bargaining over fees for program services that generate an increment in revenue to cable systems only slightly larger than the costs of the program service, where those costs are the minimum amounts the service could pay and still purchase rights to its programming.[39] Significantly, however, the amount paid by a single large buyer such as AT&T for one program service is unlikely to affect the price it pays for all other services. Thus, for example, a perfectly price-discriminating monopsonist would pay only the minimum amount necessary for each program service, an amount that would be unaffected by the number or identity of other program services that it purchases. In the more realistic case, in which AT&T shared rents with program services, it could avoid having the bargaining over the rents for one program service affect the prices it pays for all others.[40] In any event, the exercise of bargaining power would not affect the identity or quality of programming that is offered.

Professor Hausman asserts the contrary. He claims that by virtue of its buying power, AT&T can force a supplier that has already incurred sunk entry costs, i.e., an established supplier, to accept a price so low that it will cause the

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[39] This does not imply that license fees would be the same for all such marginally profitable services. The levels of costs and of incremental revenues could, and probably do, vary substantially across such services.

[40] Even where it is in the joint interest of the cable system and the program service to have the cable system carry the service, one can imagine the program service posturing for a larger share of the rents. In these cases, it is possible that some "mistakes" will be made, and the carriage of some services may be delayed.

supplier to incur losses over the lifetime of the service (Hausman's "holdup" contention). However, at least with respect to the supply of program services to MVPDs, this kind of behavior is unlikely to be empirically important. If AT&T were to engage in such opportunism, the quality of programming available to it would decline over time and it (and other MVPDs) would experience a reduction in profits. The loss in future profits deters AT&T from engaging in such behavior.

In fact, the potential for bargaining power to reduce the amount of programming supplied might be greater if all cable MSOs were smaller. A small MSO is less likely to consider the effect of price paid on the survival of the program service, or on the quality of programming, since the license fee it pays will generally be too small to have a substantial effect on the program service.

Taking the contract with a single small MSO in isolation, the program service is better off selling rather than not selling so long as the revenue received covers the *incremental* cost of supplying this small MSO. However, if many small MSOs could force the program service to accept less than the *average* cost of supplying them, the supply of programming could be restricted.

AT&T will be constrained in its bargaining, in a way many small MSOs would not, by the knowledge on the part of both MSO and program service that the total costs of the program service must be covered.[41] Thus, there is a significant constraint on the exercise of bargaining power by AT&T.

[41] In addition, as pointed out below, being able to deal with larger MSOs may reduce the transaction costs of arranging the buying commitments that program services may require in order to begin offering new services and to make substantial quality improvements in existing services.

Summary

Both before and after the merger, AT&T is not likely to be able to wield monopsony power. The measures of market concentration on which Hausman and CFA rely for inferring AT&T's ability to exercise monopsony power, and the conceptual basis for the inferences themselves, are flawed and are therefore not a valid indicator of the effect of the merger on either the incentive or ability of AT&T-MediaOne to exercise that power. In addition, the program services purchased by AT&T and other MVPDs compete for inputs in a much broader market with broadcast television and theatrical movies and the purchases of program services by AT&T account for only a small fraction of the input sales in this broad market.

Finally, even if AT&T had the ability and incentive to exercise monopsony power, it would not, in contrast to what Hausman suggests, likely pay a price for a service that would cause that service to be unprofitable. Such behavior would discourage the development of the critical inputs — programming — required by AT&T (and other MVPDs). Thus, any bargaining power AT&T might have would not lead to a reduction in program output or quality. Moreover, after the acquisition of MediaOne, AT&T will have an increased incentive to encourage the development of program services.

License Fee Discounts

In their paper, "The Economics of License Fee Discounts,"[42] James Dertouzos and Steven S. Wildman (hereafter "DW") claim (1) that small cable operators, including new entrants, pay significantly higher prices for programming than do large incumbent cable operators; (2) that these rate differences are justified neither by "true cost differences nor legitimate business incentives"[43] and, therefore, (3) that the rate differences are a barrier to effective competition in the supply of multichannel video services.[44] However, the evidence and analysis presented by DW do not support these conclusions.

In particular, DW's estimates of the discount obtained by large cable MSOs are likely to be highly inaccurate and their attempt to ascribe virtually their entire estimated difference to bargaining power on the part of large MSOs is defective because they fail to recognize the large number of cost and efficiency-based explanations for any differences that actually exist.

Program Service Prices

DW first attempt to quantify the differences between the fees paid by larger MSOs and those paid by smaller MVPDs. They then purport to show that differences in rates as large as those they have quantified could not be based on cost, but instead must primarily represent the exercise of bargaining power by the

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[42] Filed as Exhibit 4 to Comments of Ameritech, *In the Matter of Applications of AT&T Corporation, Transferee and MediaOne Group, Inc., Transferor ("MediaOne") For FCC Consent to Transfer of Control Pursuant to Sections 214 and 310(d) of the Communications Act, as Amended, of Licenses and Authorizations held by Subsidiaries of MediaOne and Entities Controlled by MediaOne*, CS Docket No. 99-251, August 23, 1999.

[43] DW, p. 14.

[44] DW never actually discuss the implications of their analysis for the AT&T-MediaOne merger.

larger MSOs. DW conclude that the result is to create a barrier to entry to new MVPDs.

There are problems with each stage of DW's argument. The authors' interpretation of the data on price differences and their analysis of the possible sources of differences in pricing are seriously flawed. Moreover, even to the extent that pricing patterns may reflect the bargaining power of large operators, this is unlikely to create a barrier to increased competition in multichannel video distribution.

The Magnitude and Sources of Program Pricing Differences

DW claim to have presented information on the magnitude of programming price discounts provided to large MSOs and then to have shown, by process of elimination, that such differences cannot be attributed to sources other than the bargaining power of such large MSOs. The fundamental problems with DW's analysis are: (1) their measures of the differences in the rates actually paid by larger and smaller MSOs are highly questionable; and (2) the authors fail to consider a wide variety of other reasons, including cost and efficiency-based reasons, for the calculated rate differences.

Reported Rate Card Discounts

DW first provide a summary of information from the rate cards for twelve cable networks. For each of these networks, DW report the number of subscribers required to qualify for the maximum discount, the magnitude of the maximum

discount, and the length of the contract.[45] However, it is very doubtful that these data are reliable estimates or indicators of cost disadvantages faced by an entrant.

First, rate card fees may differ substantially from the fees negotiated and actually paid by MSOs. Many MSOs — not only the very largest — pay negotiated fees that differ from rate card fees.[46] Indeed, DW never actually claim that the rate card rates are being paid by anyone.[47] If entrants and small MVPDs can negotiate rates that are lower than those in the rate cards employed in their calculations, DW's estimate of the cost disadvantage faced by an entrant (or a small cable operator) could be overstated.

Second, DW's calculations are based on the rate cards for only twelve networks, and there is no way of knowing how representative this sample is because these networks are not identified.[48] Indeed, even among the networks for which DW do provide information, there are substantial differences with respect to both the magnitude of the maximum discounts offered and the number of subscribers required to qualify for those discounts.

Third, the magnitude of the maximum discount and the numbers of subscribers required to qualify for some discounts — and in some cases for the maximum discount — can be quite modest. Rate cards for two of the networks are reported to offer maximum discounts of only 2.7 and 7.4%. One network offers a

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[45] DW, Table 1, p. 6.

[46] DW (p. 5) state that "smaller MVPDs apparently have little choice but to pay the card rates" but they provide no evidence that this is the case. At another point (p. 10), they claim that "small MVPDs receive either small or no discounts."

[47] DW refer (p. 5) to "contracts" between networks and MVPDs but their analysis is based entirely on rate cards and not on any actual agreements.

[48] DW, p. 5, footnote 4 indicates that the authors cannot identify these networks.

discount to an MVPD with only 1,000 subscribers, one offers discounts to MVPDs with 50,000 subscribers, and four offer discounts to an MVPD with only 100,000 subscribers.[49] These are very modest numbers of subscribers for an entrant to reach, particularly an entrant seeking to compete in metropolitan areas. Indeed, no fewer than 51 cable MSOs would qualify for discounts on those four networks that require a minimum of 100,000 subscribers.[50] For six networks, even the maximum discount is available to an MVPD that reaches as few as 2% of all MVPD subscribers.

Comparison of Top of the Rate Card Rates and Average Fees

DW recognize that rate cards may not reflect actual fees paid by distributors for programming, so they present alternative calculations based on data for basic cable networks reported by Paul Kagan Associates, which the authors claim are "more realistic" estimates of the cost disadvantage faced by entrants. For each of 33 basic cable networks, DW report the difference between the "top of the rate card" fee for 1997 and the reported average license fee paid in 1997. DW then examine whether distribution and transaction cost savings or other efficiencies can explain the observed differences. They conclude that these differences cannot be ascribed to the greater efficiencies of transactions with large MSOs and that, therefore, they are due to the greater bargaining power of large cable operators. Both the evidence presented and the explanations offered are, however, unsatisfactory.

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[49] Many of these are among the networks reported to offer large discounts.

[50] Kagan's *Cable TV Investor*, "Top-100 Cable System Operators, as of September 1998," No. 536, March 3, 1999, lists 51 MSOs with more than 100,000 subscribers.